



**REPORT OF THE AUDITOR OF PUBLIC ACCOUNTS  
AUDIT OF THE REVENUE CABINET**

**Made as Part of the Statewide Single Audit  
of the Commonwealth of Kentucky**

**For the Year Ended June 30, 2001**

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## **EXECUTIVE SUMMARY**

### **Report of the Auditor of Public Accounts Audit of the Revenue Cabinet For the Year Ended June 30, 2001**

**BACKGROUND:** The Single Audit Act of 1984, subsequent amendments, and corresponding regulations, require the auditing of financial statements and the compliance and internal controls applicable to federal moneys received by the Commonwealth. To comply with these requirements, we audited internal controls and compliance at both the central and agency level. This summary is on our audit of one (1) organizational unit of the Commonwealth, the Revenue Cabinet.

**RECEIPTS:** The Revenue Cabinet received \$6,390,921,097 in General Fund receipts and \$753,954,993 in Transportation Fund receipts for the fiscal year ended June 30, 2001 through various tax types. We audit the largest of these revenue programs annually as part of our Statewide Single Audit.

#### **SUMMARY OF AUDITOR'S RESULTS:**

##### **Financial Statement Accounts**

There were six (6) new audit findings for FY 01. Many of the problems noted in prior year audits continue to exist. The Modernized Front End (MFE) was fully operational for certain tax types during FY 01 and enabled the Revenue Cabinet to process tax returns more efficiently. However, the MFE did not resolve many of the deficiencies noted in prior audits as was initially expected.



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## **INTRODUCTION**





**KENTUCKY REVENUE CABINET  
INTRODUCTION  
FOR THE YEAR ENDED JUNE 30, 2001**

Introduction

The Auditor of Public Accounts (APA), acting as principal auditor in conjunction with various certified public accounting firms, annually performs a statewide single audit of the Commonwealth of Kentucky. This audit allows the Commonwealth to comply with federal audit requirements as set forth in the Single Audit Act of 1984, as amended by Public Law 104-156, and the regulations contained in the Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

Schedule of Findings and Questioned Costs

The Schedule of Findings and Questioned Costs consists of three (3) sections:

- Summary of Auditor's Results,
- Financial Statement Findings, and
- Federal Award Findings and Questioned Costs.

The audit finding number and classification (as reportable, material, or other matter) are provided as part of the audit opinion summary. Major programs audited are listed on the Summary of Auditor's Results. The Financial Statement Findings list the audit findings related to the financial statements (required to be reported in accordance with *Government Auditing Standards*). The Federal Award Findings and Questioned Costs lists all findings related to federal awards. Generally, the state agency, CFDA number and program, federal agency, pass-through agency, and the compliance area to which the finding relates are presented. In both reports, reportable conditions and reportable instances of noncompliance are presented first, then material weaknesses and material instances of noncompliance, followed by other matters.

Audit findings reported in the Schedule of Findings and Questioned Costs for the fiscal year ended June 30, 2000, as well as any previous findings which have not been resolved, are reported in the Summary Schedule of Prior Audit Findings for the fiscal year ended June 30, 2001. If the APA determines the agency's Summary Schedule of Prior Audit Findings materially misrepresents the status of any prior audit finding, a new audit finding is issued and reported in the Schedule of Findings and Questioned Costs.

The Summary Schedule of Prior Audit Findings is organized based on whether the prior year finding was reportable, material, or other matter. The findings of each classification are categorized as (1) fully corrected, (2) not corrected or partially corrected, (3) corrective action taken differs significantly from corrective action previously reported, or (4) finding no longer valid or does not warrant further action.

**KENTUCKY REVENUE CABINET  
INTRODUCTION  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

Audit Approach

Our audit was conducted in accordance with the Single Audit Act Amendments of 1996, OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, *Government Auditing Standards* (also referred to as the Yellow Book), and auditing standards generally accepted in the United States of America. The scope of the statewide single audit for the year ended June 30, 2001 included:

- An audit of the general-purpose financial statements and required supplementary schedules in accordance with auditing standards generally accepted in the United States of America;
- An audit of the internal control applicable to the Kentucky Revenue Cabinet (KRC) to the extent necessary to consider and test the internal accounting and administrative control systems as required.

The APA conducted the audit of internal controls, focusing on the following objective:

- Considering the internal control in order to determine auditing procedures on the general-purpose financial statements of the Commonwealth.

List of Abbreviations/Acronyms Used in This Report

APA	Auditor of Public Accounts
BDC	Backup Domain Controllers
CFDA	Catalog of Federal Domestic Assistance
Commonwealth	Commonwealth of Kentucky
EFT	Electronic Funds Transfer
FY	Fiscal Year
GOT	Governor's Office for Technology
JCL	Job Control Language
KRC	Kentucky Revenue Cabinet
KRS	Kentucky Revised Statutes
LAN	Local Area Network
MFE	Modernized Front End
N/A	Not Applicable
OMB	Office of Management and Budget
PDC	Primary Domain Controllers
RACF	Resource Access Control Facility
REV	Revenue Cabinet
Revenue	Revenue Cabinet
SQL	Structured Query Language
TAD	Turn Around Document
TSO	Time-sharing Option
U.S.	United States

**REPORT ON COMPLIANCE AND ON INTERNAL CONTROL**





EDWARD B. HATCHETT, JR.  
AUDITOR OF PUBLIC ACCOUNTS

Report on Compliance and on Internal Control Over Financial Reporting  
Based on an Audit of the General-Purpose Financial Statements  
Performed in Accordance With *Government Auditing Standards*

To the People of Kentucky  
Honorable Paul E. Patton, Governor  
Dana Mayton, Secretary  
Kentucky Revenue Cabinet

As part of the audit of the general-purpose financial statements of the Commonwealth of Kentucky as of and for the year ended June 30, 2001, we have audited receipts, refunds, account receivables, and contingent liabilities of the Kentucky Revenue Cabinet, an organizational unit of the Commonwealth as defined by KRS 12.010, and have issued our report thereon dated December 21, 2001. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Commonwealth's financial statements are free of material misstatement, we performed tests of Kentucky Revenue Cabinet's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Report on Compliance and on Internal Control Over Financial Reporting  
Based on an Audit of the General-Purpose Financial Statements  
Performed in Accordance With *Government Auditing Standards*  
(Continued)

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Revenue Cabinet's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Revenue Cabinet's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 01-REV-1, 01-REV-2, and 01-REV-3.

A material weakness is a condition in which the design or operation of one (1) or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider item 01-REV-3 to be a material weakness. We also noted other matters involving the internal control over financial reporting, which we have reported to the management of the Revenue Cabinet and is described in the accompanying schedule of findings and questioned costs of this report.

This report is intended solely for the information and use of management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Sincerely,



Edward B. Hatchett, Jr.  
Auditor of Public Accounts

December 21, 2001

**SCHEDULE OF FINDINGS AND QUESTIONED COSTS**





**KENTUCKY REVENUE CABINET  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2001**

**SECTION 1 - SUMMARY OF AUDITOR'S RESULTS**

**Financial Statement Accounts**

Financial Statement Accounts: We issued an unqualified opinion on the Commonwealth's general-purpose financial statements which included the Revenue Cabinet, as of and for the year ended June 30, 2001.

Internal Control Over Financial Reporting: Our consideration of the Revenue Cabinet's internal control over financial reporting disclosed three (3) reportable conditions. We consider one (1) of the reportable conditions a material weakness.

The reportable conditions and material weaknesses are presented in detail in Section 2 – Financial Statement Findings of the Schedule of Findings and Questioned Costs.

Compliance: The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

**Federal Awards and Schedule of Expenditures of Federal Awards**

This section is not applicable to the Revenue Cabinet.

**Identification of Major Programs Audited**

This section is not applicable to the Revenue Cabinet.

**Dollar Threshold Used to Distinguish Between Type A and Type B Programs**

This section is not applicable to the Revenue Cabinet.

**Auditee Risk**

The Commonwealth did not qualify as a low-risk auditee.

**KENTUCKY REVENUE CABINET  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

**SECTION 2 - FINANCIAL STATEMENT FINDINGS**

***Reportable Conditions Relating to Internal Controls and/or Reportable  
Instances of Noncompliance:***

**FINDING 01-REV-1: The Revenue Cabinet Should Update The Sales Tax Database  
And Automate Processing Of Accelerated Tax Returns**

We requested an Electronic Funds Transfer (EFT) report from the Revenue Cabinet's (Revenue) Department of Information Technology, Office of Application Engineering detailing all tax payments that equaled or exceeded \$1,000,000 during FY 01; the report had 207 payments that met our criteria. We then selected all items we deemed as individually significant for the General Fund. We identified and tested 12 sales tax returns that met our criteria, totaling \$154,767,855 in tax payments. During testing, we noted the following problems:

- Revenue sales tax database does not process payments that equal or exceed \$1,000,000, thus a single transaction exceeding \$1,000,000 will show up on the Revenue mainframe report as 999,999 in a succession of lines with the bottom line total as the balancing amount. While this is a system limitation, data processed in this manner is difficult for end users to understand.
- Significant clerical errors were found in the manual processing of accelerated sales tax returns that were not detected and corrected by the existing internal control structure. We noted a clerical error, in one (1) month's tax return, resulting in a \$4,545,738 overstatement of the taxpayer's pre-payment. The second instance resulted in a \$3,000,623 overstatement of the taxpayer's pre-payment. All accelerated sales tax returns are manually processed in the sales tax section, since the Modernized Front End (MFE) is not set up to process these returns. The accelerated taxpayers make a pre-payment of sales tax each month of an estimated 50% of the next month's tax payment.

During FY 01, Revenue automated the processing of its high volume sales and use and withholding tax returns through the MFE. The MFE is used for scanning tax returns for posting to the Revenue's mainframe, depositing receipts, and imaging returns for archiving purposes. Revenue users with access to the FileNet System are able to view images of all items in a transaction that are scanned into the MFE.

While FY 01 financial statement information was not affected as a result of these weaknesses and errors, the system limitation could affect the accuracy and reliability of the Revenue reporting system. Tax information that is not captured exactly as reported on the tax return makes it difficult to determine if receipts were recorded at the proper amounts. Also, since the tax information is difficult to track, the likelihood that errors will go undetected by Revenue increases.

**KENTUCKY REVENUE CABINET  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

**SECTION 2 - FINANCIAL STATEMENT FINDINGS**

**FINDING 01-REV-1: The Revenue Cabinet Should Update The Sales Tax Database And Automate Processing Of Accelerated Tax Returns (Continued)**

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The system weaknesses, noted herein, represent deficiencies in the design and operation of internal controls that could result in violations of laws and regulations which would materially affect Revenue's financial reporting. Good internal controls dictate receipts should be properly posted to computer records from supporting documentation and all data processed by significant systems should have the proper review and audit to determine accuracy and completeness.

**Recommendation**

We recommend Revenue take the following actions to correct these weaknesses:

- Make the appropriate adjustments to correct the affected reports and accounts;
- Update Revenue's mainframe system to process tax payments that equal or exceed \$1,000,000; and,
- Program the MFE to process all accelerated sales tax returns; this would reduce manual processing and should increase mathematical accuracy, which would increase the reliability of the mainframe data. If this isn't feasible, due to the magnitude of the tax payments involved, all accelerated sales tax returns should have a secondary level of review that includes verifying, editing, and approving all adjustments.

**Management's Response and Corrective Action Plan**

*The Kentucky Revenue Cabinet (KRC) agrees with the auditor's recommendation regarding the correction of the clerical errors. The appropriate adjustments are currently in the process of being corrected by a Sales Tax Section unit supervisor. The clerical errors noted by the auditor resulted from one (1) employee temporarily assigned to the Sales Tax accelerated program from another taxing area. That employee assisted in the accelerated returns for a short time to help alleviate a sizable number of unworked returns. That situation has now been corrected so that the inventory has been greatly reduced to a more manageable level, and, only 2 to 3 experienced Sales Tax employees, under the direct supervision of an experienced Sales Tax unit supervisor, now work the accelerated sales tax returns.*

*Regarding the recommendation to update the Revenue mainframe system, to process payments that equal or exceed \$1,000,000, the Cabinet concurs. The sales tax system is approximately 25 years old and is due for a major overhaul.*

**KENTUCKY REVENUE CABINET  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

**SECTION 2 - FINANCIAL STATEMENT FINDINGS**

**FINDING 01-REV-1: The Revenue Cabinet Should Update The Sales Tax Database And Automate Processing Of Accelerated Tax Returns (Continued)**

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**Management's Response and Corrective Action Plan (Continued)**

*The Cabinet previously considered replacing or extensively overhauling the system. However, the cost to replace the system is prohibitive at this time. Additionally, there are national discussions regarding a uniform sales tax base and rate. The outcome of the national debate regarding the future of sales tax could be applicable to Kentucky in the very near future. Without knowing the outcome of those discussions, Kentucky cannot proceed with major system changes at this point in time.*

*The Kentucky Revenue Cabinet (KRC) agrees that processing Accelerated Sales Tax returns on the MFE would reduce manual processing and increase mathematical accuracy, which would increase the reliability of mainframe data. Programming to allow such processing should be completed during the MFE restructuring, which is scheduled to be implemented in July 2002. For those Accelerated Sales Tax returns processed manually at Revenue Operations, a TAD is created which is subsequently worked by Compliance. It should be noted that the process of creating TAD's on all accelerated returns does create a "secondary level of review" conducted after the initial processing of the return.*

**FINDING 01-REV-2: The Revenue Cabinet Should Have A System In Place To Reconcile Critical Information**

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Revenue does not have a system in place to input or reconcile critical information to the mainframe system; this continues to be a problem for Revenue as this has been reported during prior year audits as well. By not performing critical reconciliations, Revenue cannot be sure that reported amounts remitted are correct. While Revenue currently has a reconciliation project underway, which is now in the detail system design phase, there was no system in place at the time of our audit.

Revenue should have adequate systems in place to ensure all taxes due to Kentucky have been collected and all taxpayers are reporting key information in compliance with state laws.

**KENTUCKY REVENUE CABINET  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

**SECTION 2 - FINANCIAL STATEMENT FINDINGS**

**FINDING 01-REV-2: The Revenue Cabinet Should Have A System In Place To Reconcile Critical Information (Continued)**

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**Recommendation**

Revenue should develop a system for reconciling critical information.

**Management's Response and Corrective Action Plan**

*The Kentucky Revenue Cabinet (KRC) agrees with the Auditor's recommendation. KRC initiated a plan during fiscal year 2001 to correct this problem. Past Auditor's comments have addressed this problem and KRC searched several years for an affordable method of addressing the issue. The new reconciliation system is expected to go live on April 1, 2002.*

**Auditor's Reply**

The new reconciliation system did not go live on April 1, 2002 as expected. However, the project is now being conducted in phases. Phase I is complete and Phase II is expected to be complete by June 12, 2002. We urge KRC to correct this deficiency as soon as possible.

***Material Weaknesses and/or Material Instances of Noncompliance:***

**FINDING 01-REV-3: The Revenue Cabinet Should Substantially Improve All System Related Controls Surrounding The Modernized Front End System**

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We reviewed the data entry controls concerning tax forms processed within the Revenue through the MFE system for fiscal year ending June 30, 2001. We noted MFE system deficiencies including system design inefficiencies and inadequacies; inaccessible software support, source code, and application monitoring; and lack of system administration controls and adequate documentation. These deficiencies have been affirmed by Revenue and a restructure of the MFE system is currently underway.

General issues of concern include:

- The logical security in place within the MFE system is not sufficient to ensure the protection of the data and programs within the system. All users who have access to the MFE process have been placed within a group that provides them full access to the application and related files contained within the MFE data server. This access level could lead to intentional or unintentional corruption or deletion of files and application programs.
- Accounting audit trails are not sufficient to trace or verify transactions or data changes.

**KENTUCKY REVENUE CABINET  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

**SECTION 2 - FINANCIAL STATEMENT FINDINGS**

**FINDING 01-REV-3: The Revenue Cabinet Should Substantially Improve All System Related Controls Surrounding The Modernized Front End System (Continued)**

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- Data preparation controls are not sufficient to ensure all documents are properly entered and posted. Currently, Revenue performs reconciliation procedures upon completion of document processing to ensure the accuracy and completeness of the transactions.

Revenue has assumed complete responsibility for the MFE system and has continued to modify program codes in an attempt to stabilize the system. Maintaining the day-to-day processing fixes to the system has not allowed necessary resources to focus on internal controls of the system or the restructuring process.

To ensure the completeness and accuracy of the data that is processed through the MFE system, several controls must be in place. First, a strong control over logical security is necessary to ensure unauthorized modifications are not made to files or programs. Second, audit trails should be maintained and kept current. These files can be used for trouble shooting as well as reporting. Finally, adequate data entry and processing controls are necessary to ensure only authorized data is being input into the system and the data entered is complete and accurate.

**Recommendation**

We recommend Revenue strengthen the controls around the MFE system. Specifically, we suggest these controls include:

- A restructuring of the current logical security for the system to remove the excessive access provided to the MFE users and to restrict access privileges based on job function.
- An enhancement of the accounting audit trails to allow the tracing or verification of transactions and data changes through the process.
- An expansion of procedures surrounding the data preparation of documents to ensure all documents received are properly entered, batched totals are accurate, and all transactions are processed through the MFE system.

Further, Revenue should be diligent in its restructuring plans to ensure known deficiencies within the system are addressed in a responsible and timely manner.

**KENTUCKY REVENUE CABINET  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

**SECTION 2 - FINANCIAL STATEMENT FINDINGS**

**FINDING 01-REV-3: The Revenue Cabinet Should Substantially Improve All System Related Controls Surrounding The Modernized Front End System (Continued)**

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**Management's Response and Corrective Action Plan**

*The Kentucky Revenue Cabinet (KRC) agrees with the Auditor's findings and is currently in the process of re-structuring the Modernized Front End (MFE) to address these issues. The estimated completion date for the MFE re-structuring is July 2002.*

***Other Matters Relating to Internal Controls and/or Compliance:***

**FINDING 01-REV-4: The Revenue Cabinet Should Implement A System For Crosschecking Motor Fuels Dealer Reports**

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The Revenue's motor fuels tax section has a significant backlog in crosschecking motor fuels dealer reports. Reports are filed with the motor fuels tax section by fuel dealers and by transporters (also known as common carriers). The Transporter's Report of Motor Fuel Delivered (Form 72A098) is filed each month by transporters, and it includes every consignee to whom motor fuel was delivered, type of fuel, number of gallons, etc. The transporter must provide one (1) duplicate of this report so that Revenue can associate it with the appropriate monthly dealer's reports. The transporter reports are tracked to ensure that each licensee is filing a monthly report and that the report is filed on time.

The backlog in crosschecking reports continues to be a problem area for the Cabinet. During the FY 01 audit, we tested 42 reports and noted 38 instances where motor fuels dealer reports were not crosschecked. The Revenue is nearly three (3) years behind in this area. This is a repeat of REV-00-1 from the prior year audit. While attempts are being made to reduce the backlog, due to state budget constraints, Revenue is not able to hire additional staff to reduce the backlog.

When dealer reports are not crosschecked, there may be errors, omissions, and irregularities that are not detected in a timely manner.

Good internal controls dictate that all available resources be utilized for ensuring that motor fuel reports are accurate.

**Recommendation**

We recommend that Revenue redesign the internal control structure in a manner that would ensure crosschecking of motor fuels dealer reports is completed at current staffing levels.

**KENTUCKY REVENUE CABINET  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

**SECTION 2 - FINANCIAL STATEMENT FINDINGS**

**FINDING 01-REV-4: The Revenue Cabinet Should Implement A System For Crosschecking Motor Fuels Dealer Reports (Continued)**

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**Management's Response and Corrective Action Plan**

*The Kentucky Revenue Cabinet (KRC) agrees with the Auditor's findings. Since the completion of the Auditor's findings during the June 30, 1999 and June 30, 2000 fiscal year audits, the KRC has taken steps to address the issue of "crosscheck" backlogs. Late last fiscal year, the KRC assigned two (2) additional revenue examiners to the Motor Fuels Tax Section to work specifically on backlog reduction. It should be noted that backlog reduction efforts are working. Two (2) audit periods ago backlogs were estimated at 5 to 7 years. Current backlogs are at three (3) years or less. The KRC anticipates the backlog reduction to continue at a consistent rate.*

**FINDING 01-REV-5: The Revenue Cabinet Should Ensure That All Tax Files Are Safeguarded**

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Revenue does not properly safeguard tax documents as required. This is a repeat comment.

During testing of Refunds, the following was noted:

- Of the 42 corporate income tax returns requested for testing, Central Files was unable to locate corporate files for five (5) of them. Also, there were three (3) instances in which the corporate income tax return was not found in the corporate income tax folder. Therefore, the auditor was unable to test documents or obtain the information to complete testing.

During our testing of individual and corporate tax refunds, Central Files took a number of weeks to find some of the returns requested, so they obviously were not readily retrievable

During our testing of accounts receivable, the following was noted:

- Of 27 returns requested, Central Files was unable to locate two (2) of them. Therefore, the auditor was unable to test documents or obtain information to complete testing.

The Central Files area appears to have inadequate procedures and/or personnel for ensuring that documents are properly accounted for, filed, and readily retrievable.



**KENTUCKY REVENUE CABINET  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

**SECTION 2 - FINANCIAL STATEMENT FINDINGS**

**FINDING 01-REV-5: The Revenue Cabinet Should Ensure That All Tax Files Are Safeguarded (Continued)**

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When documents cannot be located, proper administration of the tax laws is jeopardized. Taxpayer information is incomplete when original documents are not present to verify amounts and dates of refunds, offsets, etc. This compromises the ability of Revenue to properly document taxpayer accounts.

Good internal controls dictate that all available resources be used to ensure that tax documents are safeguarded.

**Recommendation**

We recommend that proper procedures be followed to ensure that all tax documents are properly accounted for and filed. Backlogs, when present, should be cleared up as soon as possible. Documents should be filed in taxpayer folders, attached to returns as appropriate, etc. as soon as possible.

**Management's Response and Corrective Action Plan**

*The Kentucky Revenue Cabinet (KRC) agrees with the Auditor's findings that sufficient staffing resources are not available, at times, at Central Files to efficiently eliminate backlogs. KRC does have appropriate procedures in place to make sure that the type errors discovered by the Auditor do not occur and will provide refresher training for its staff and management in an attempt to avoid these errors in the future.*

*However, during fiscal year 2001, KRC began scanning and imaging returns for certain type taxes when they were requisitioned from Central Files. Once scanned and imaged, these returned are indexed and can be viewed on FILENET by any KRC employee with proper security access. Additionally, any type return that would have been microfilmed in the past is now scanned. Accessibility will be greatly improved with FILENET.*

**KENTUCKY REVENUE CABINET  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

**SECTION 2 - FINANCIAL STATEMENT FINDINGS**

**FINDING 01-REV-6: The Revenue Cabinet Should Review Data Entry Logs To Ensure Completeness And Appropriateness Of Data Entry Procedures**

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During our FY 01 audit of Revenue, we examined three (3) months of the data entry logs for 14 tax payment types to ensure the completeness of processing and the proper separation of duties between the entry operator and the verifying operator. In 14 instances, we discovered that the logs were either incomplete or the logs documented the failure to properly segregate duties.

The following exceptions were noted:

- In two (2) instances, the data entry operator did not sign the log for a batch. Both occurrences were noted in the A-Series logs.
- In seven (7) instances, the same operator performed the entry and verification functions. Five (5) occurrences were found in the declaration logs. Also, single occurrences were noted in both the sales and use tax and the refund logs.
- In five (5) instances, the key verifier did not sign the log for a batch. Two (2) occurrences were noted in both the A-Series and the accounts receivable logs.

Data entry logs help to ensure that all returns were entered into and verified through the applicable systems. They also serve to document the identity of the operator that entered the data and verified the accuracy of the entered data. Not having complete data entry logs, or ensuring that data is entered and verified by different operators, increased the possibility of data entry errors.

A complete log recording the date of entry, the original entry operator number, and the verifying operator number should be kept. The log should be reviewed daily for missing information and batches that were entered and verified by the same operator. Further, data entered into the computer system should be verified unless there are sufficient compensating internal controls in operation to ensure the accuracy of the data. An operator other than the original entry operator should perform any verification needed.

**Recommendation**

We recommend that data entry section supervisors ensure that all batches are keyed and verified by separate operators.

Further, supervisors should review data entry logs daily to ensure completeness of the logs and proper segregation of duties for data entry.

**KENTUCKY REVENUE CABINET  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

**SECTION 2 - FINANCIAL STATEMENT FINDINGS**

**FINDING 01-REV-6: The Revenue Cabinet Should Review Data Entry Logs To Ensure Completeness And Appropriateness Of Data Entry Procedures (Continued)**

**Management's Response and Corrective Action Plan**

*The Kentucky Revenue Cabinet (KRC) agrees with the Auditor's recommendation that procedures should be implemented to insure that the operator verifying work is not the same person entering the batch of work. Our procedures clearly define how to properly log work in and log it out again to verify. We believe that the instances cited by the Auditor are instances of human error and not instances of incorrect policies. The KRC will again re-train the data entry supervisors in the importance of proper data entry procedures, as well as, reviewing the data entry logs on a daily basis.*

**FINDING 01-REV-7: The Revenue Cabinet Should Improve Security Controls For TSO Logical Access**

Revenue did not provide adequate logical security controls for access to the Job Control Language (JCL) and production libraries. During our review, we found five (5) user ids allocated to the Governor's Office for Technology (GOT) programmers had "Update" access via Time-sharing Option (TSO) to Revenue production or backup JCL libraries. The Revenue administrator removed these access levels after being informed of their existence and confirming that the access was no longer required. However, this inappropriate access was in effect for the fiscal year under audit; therefore, the agency was at risk during that time period to the potential that an unauthorized change could be made to programs, JCL, or data.

Additionally, our review revealed that there were six (6) user ids associated with individuals that had retired or transferred from Revenue that had "Update" or "Alter" authorization to Revenue JCL or production libraries. These user ids have been disabled through RACF. However, the specific access rights to the JCL and production libraries were not removed.

Update access to Revenue libraries and production data should be restricted to appropriate Revenue staff only. Failure to maintain proper segregation of duties for GOT programmers increases the likelihood that an unauthorized change is possible to programs, JCL, or data. A strong control environment would not allow programmers access without adequate authorization and oversight. Further, allowing access levels to remain within the RACF system after users have left the employ of Revenue could potentially allow unauthorized access to the JCL and production libraries. If these user ids were reissued to other individuals, unauthorized access rights could be inadvertently provided to the new user.

**KENTUCKY REVENUE CABINET  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

**SECTION 2 - FINANCIAL STATEMENT FINDINGS**

**FINDING 01-REV-7: The Revenue Cabinet Should Improve Security Controls For TSO Logical Access (Continued)**

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**Recommendation**

We recommend Revenue improve their logical security controls by implementing the following logical access security controls:

- Update/Alter access to Revenue JCL and production libraries should be restricted to Revenue staff only.
- Any necessary Update or Alter access granted to GOT programmers should be documented and monitored closely by Revenue management. In addition, access should be restricted to the level required to perform the assignment for a set time period and then rescinded. Alternately, Revenue can grant access to GOT programmers to a copy of required files. The programmer can then manipulate the programs/data in a test environment, thereby, limiting the necessity to closely monitor the manipulation of this data. Upon completion of the necessary changes, uploads to actual production files will be completed by Revenue staff.
- We are recommending that Revenue request and review a listing of those individuals with TSO access to its JCL and production libraries. All access rights for individuals that no longer work for Revenue, or no longer require access, should not merely be disabled, but removed.

**Management's Response and Corrective Action Plan**

*KRC agrees that access to the Revenue JCL and production libraries should be restricted to limited KRC staff only. All GOT staff access that was found has been removed. From this point forward, all access requested by GOT staff will be reviewed closely by the Director of Technology Infrastructure Support and will require a reasonable access end date. KRC Security Staff will work with GOT to review all access to the JCL and Production libraries and will remove all access of those who have retired or transferred from the cabinet.*

**KENTUCKY REVENUE CABINET  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

**SECTION 2 - FINANCIAL STATEMENT FINDINGS**

**FINDING 01-REV-8: Revenue Should Establish A Formal System To Manage Processing Errors**

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During our FY 01 Revenue audit, the manual monthly balancing procedures for the Sales and Use Tax System were reviewed to ensure that all transactions were accurately captured and preserved during processing. We found incidents in three (3) months where the balancing procedures resulted in processing errors totaling an overall \$40,112.84 in taxes. The source of these errors was not found. Further, sufficient procedures were not in place to ensure that attempts at resolution were properly documented.

Processing error identification is dependent upon the manual monthly balancing procedures. We noted weaknesses with Revenue's balancing and error correction procedures as follows:

- Supervisory reviews of the balancing procedures are currently not required, although supervisory assistance is provided as needed.
- Formalized error handling procedures are not in place to provide guidance in the event of problems or errors. This was significant for Revenue because institutional knowledge of the system was lost due to the high employee turnover in the department for the fiscal year under audit.
- The audit trail available for the Sales and Use Tax System does not provide adequate information to accurately trace the error to the underlying cause.

The monthly balancing procedures provide a means to ensure that unauthorized additions, removals or alterations of data do not occur during processing; that data integrity is maintained; and that all transactions, accounts, and resulting reports are accurate and reliable.

**Recommendation**

We recommend that Revenue define, document, and implement a formal system for managing processing errors to ensure all problems are captured, recorded, analyzed, and resolved. These procedures should at least include the following:

- Support requirements for documenting the error or problem.
- Standardized report format for reporting errors.
- Line of communication establishment for error reporting.
- Responsibilities for incident analysis and resolution.

**KENTUCKY REVENUE CABINET  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

**SECTION 2 - FINANCIAL STATEMENT FINDINGS**

**FINDING 01-REV-8: Revenue Should Establish A Formal System To Manage Processing Errors (Continued)**

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**Recommendation (Continued)**

We also recommend that Revenue develop automated monthly balancing procedures for all applicable tax types and require that supervisors review the balancing to ensure errors are not overlooked. Further, Revenue should review the usefulness of audit trails for incident research.

**Management's Response and Corrective Action Plan**

*Systems Support Branch, within the Division of Systems Planning and Development, and the KRC's Internal Auditor have reviewed the three (3) months in question and continue to research these errors. They have also developed a spreadsheet which will assist the Systems Support Branch in their efforts to reconcile Sales and Use Tax receipts. This will be a standardized report that will document all errors and identify those employees who assisted in the analysis and correction of errors. Similar electronic spreadsheets are being developed for all tax systems and will also be available for use within the Cabinet for statistical analysis.*

*Each individual employee is responsible for notifying their supervisor and the supervisor of the Business Analyst Team of problems associated with receipts balancing. All balancing errors will be thoroughly researched and documented in a timely manner. In addition, documentation used to research and correct the balancing errors will be maintained for auditing purposes.*

**FINDING 01-REV-9: Revenue Password Policy Should Be Consistently Applied To All Local Area Network Servers**

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During the FY 01 audit, we reviewed the password policies of all Primary Domain Controllers (PDC), Backup Domain Controllers (BDC), and Structured Query Language (SQL) servers within the three (3) main domains maintained by Revenue. It was found that the password policies established on one (1) PDC server, two (2) BDC servers, and ten (10) SQL servers did not adhere to the agency password policy set forth in their Standard Procedure #5.2 – User ID and Passwords.

To help ensure the security of a network, it is necessary for a strong password policy to be developed and implemented on all servers within the network. If servers within a network are not sufficiently secured, the network could be compromised through one (1) of these more vulnerable paths.

**KENTUCKY REVENUE CABINET  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

**SECTION 2 - FINANCIAL STATEMENT FINDINGS**

**FINDING 01-REV-9: Revenue Password Policy Should Be Consistently Applied To All Local Area Network Servers (Continued)**

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**Recommendation**

We recommend that Revenue review all servers within their agency-owned domains to ensure that the password policy established on all servers complies with the guidelines specified by the agency.

**Management's Response and Corrective Action Plan**

*The Kentucky Revenue Cabinet (KRC) has reviewed all servers that were reported as not being compliant and the policies have been corrected according to Standard Procedure 5.2. All other KRC servers will be reviewed within the next few weeks. In the future, we will ensure that all new servers are in compliance with the password policy set forth in Standard Procedure #5.2 – Userid and Passwords.*

**FINDING 01-REV-10: Revenue Cabinet Should Ensure That Information Leakage Concerning Agency Devices Is Minimized**

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Revenue should restrict critical information divulged through normal scans of their processing servers. During the review of Revenue's LAN security for fiscal year 2001, and using standard scanning tools, we reviewed the server names and other remarks for all servers located within the three (3) domains maintained by Revenue. We noted server names and remarks that would divulge the location of the domain's PDC, BDC, or SQL servers.

Within all three (3) domains, the naming convention of servers was not sufficiently ambiguous to disguise the function of some of the servers. There are servers that use readily recognizable lettering combinations within the server names such as "PDC" – Primary Domain Controller, "BDC" – Backup Domain Controller, "SQL" – Structured Query Language, "DHCP" – Dynamic Host Configuration Protocol, "DOCCTR" – Document Center, and "PNTSVR" – Print Servers. Further, within two (2) of the domains, there are remarks that denote PDC, BDC, and SQL servers. Some of the remarks also provided the location of these servers.

**KENTUCKY REVENUE CABINET  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

**SECTION 2 - FINANCIAL STATEMENT FINDINGS**

**FINDING 01-REV-10: Revenue Cabinet Should Ensure That Information Leakage Concerning Agency Devices Is Minimized (Continued)**

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An agency's domain information accessible to the world at large through inquiry tools should be kept at a minimum. Agencies should ensure that information such as location, data residing on the device, and the server's role is either not divulged or stated in the most minimal of terms. To accomplish this, an agency can set devices to not respond to certain types of inquiries, can use naming conventions that obscure the purpose of servers, and can provide no comments on server activity.

**Recommendation**

We recommend that Revenue review the naming convention for servers and make them more ambiguous to help ensure that sensitive servers cannot be easily identified by name. Further, any unnecessary comments associated with the servers should be removed.

**Management's Response and Corrective Action Plan**

*KRC network staff has already started taking steps to correct this problem as a result of discussions at the Network Security Summit that we attended in November. We have adopted a new naming convention and have started using it on the few new servers that have been added to the network this month.*

*KRC will discontinue the use of "REV" as the beginning characters for all of our server names and will use ambiguous names that will not reflect the function of the server. We are in the process of working with development staff to identify any instances of server name being embedded in current applications. This must be done before servers can be renamed so as to not interrupt production systems. Network Staff will remove all unnecessary remarks in order to prevent the divulging of information that could assist someone in compromising our network.*

**SECTION 3 - FEDERAL AWARD FINDINGS AND QUESTIONED COSTS**

There were no federal award audit findings and questioned costs.



**SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS**



**KENTUCKY REVENUE CABINET  
SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS  
FOR THE YEAR ENDED JUNE 30, 2001**

<b>Fiscal Year</b>	<b>Finding Number</b>	<b>Finding</b>	<b>CFDA Number</b>	<b>Questioned Costs</b>	<b>Comments</b>
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**Reportable Conditions**

***(1) Audit findings that have been fully corrected:***

There were no findings for this section.

***(2) Audit findings not corrected or partially corrected:***

There were no findings for this section.

***(3) Corrective action taken is significantly different from corrective action previously reported:***

There were no findings for this section.

***(4) Audit finding is no longer valid:***

There were no findings for this section.

**Material Weaknesses/Noncompliances**

***(1) Audit findings that have been fully corrected:***

There were no findings for this section.

***(2) Audit findings not corrected or partially corrected:***

There were no findings for this section.

***(3) Corrective action taken is significantly different from corrective action previously reported:***

There were no findings for this section.

***(4) Audit finding is no longer valid:***

There were no findings for this section.

**KENTUCKY REVENUE CABINET  
SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

<b>Fiscal Year</b>	<b>Finding Number</b>	<b>Finding</b>	<b>CFDA Number</b>	<b>Questioned Costs</b>	<b>Comments</b>
<b><u>Other Matters</u></b>					
<i>(1) Audit findings that have been fully corrected:</i>					
There were no findings for this section.					
<i>(2) Audit findings not corrected or partially corrected:</i>					
2000	00-REV-1	The Revenue Cabinet Should Review Data Entry Logs To Ensure Completeness And Appropriateness Of Data Entry Procedures	N/A	0	Exceptions were noted during FY 01 testing.
1998	KRC-3	The Revenue Cabinet Should Ensure That Motor Fuel Reports Are Cross-Checked as Required	N/A	0	Previously the backlogs ranged from 5-7 years; current backlogs are at three years or less. KRC anticipates the backlog reduction to continue at a consistent rate.
1997	KRC – 7	The Revenue Cabinet Should Properly Safeguard Corporation Tax Returns	N/A	0	During FY 01, KRC began scanning and imaging returns for certain type taxes. Once scanned and imaged, these returns are indexed and can be viewed on FILENET by any KRC employee with proper security access.
1998	KRC-1	The Revenue Cabinet Should Properly Safeguard Returns	N/A	0	During FY 01, KRC began scanning and imaging returns for certain type taxes. Once scanned and imaged, these returns are indexed and can be viewed on FILENET by any KRC employee with proper security access.

**KENTUCKY REVENUE CABINET  
SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS  
FOR THE YEAR ENDED JUNE 30, 2001  
(CONTINUED)**

<b>Fiscal Year</b>	<b>Finding Number</b>	<b>Finding</b>	<b>CFDA Number</b>	<b>Questioned Costs</b>	<b>Comments</b>
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**Other Matters**

*(3) Corrective action taken is significantly different from corrective action previously reported:*

There were no findings for this section.

*(4) Audit finding is no longer valid:*

There were no findings for this section.